RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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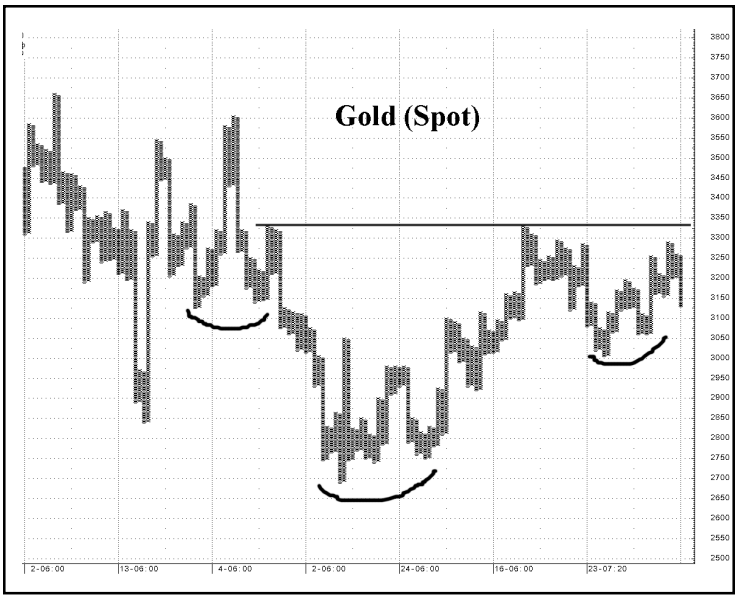
LETTER 1343

October 23, 2002

Oct. 4, DJIA 7528.75; PTI 5212; A-D Ratio -5.32
Oct. 11, DJIA 7844.88; PTI 5214; A-D Ratio -5.60
Oct. 18, DJIA 8322.40; PTI 5223; A-D Ratio -5.14
S&P Yield: 1.79% S&P p/e: 33.07
Gold 50-Day MA: 309

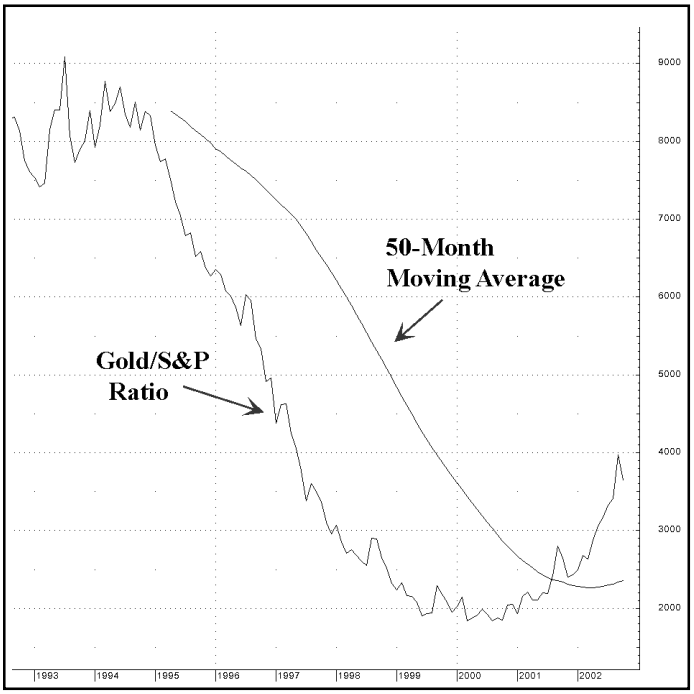
GOLD – I'm going to start this Letter with two very important charts. The first is a point & figure chart of gold going back to 1999. What I want to point to is this huge "head-and-shoulders" bottom formation. This is not just any old formation; it's a HUGE formation.

As I see it, this is a picture of accumulation. It's a picture of patience, of watchful waiting. At what point would this chart turn clearly bullish? It would turn bullish if or when gold breaks out above 330.



When might that happen? Frankly, I don't know nor does anyone else know. But the accumulation is there; the base formation is there. The chart is "telling us" that somewhere ahead gold is going to move up and break out above 330. In the meantime, it's accumulation time for gold and gold shares.

Gold and the S&P – Here's the secret that the anti-gold crowd doesn't want you to know about. It's a monthly chart showing gold divided by the S&P. In September 2000 this ratio turned up in favor of gold. In August 2001 the ratio broke up above its 50-month moving average. The chart is telling us that gold, the metal, has outperformed stocks (the S&P) for the last two years. And as you can see on the chart, this situation is accelerating.



THE PICTURE — Ask the average person what the two greatest forces for profitable investing are, and my guess is that the great majority will not have a clue. Don't believe me? Test it; ask your husband or wife or friend or your kids. The answer to the question is first — the primary trend of the market, and second — compounding.

I try to make it very simple. I want my subscribers to use both of these incredible forces. Everything else aside from these two forces is extraneous. Everything else is a diversion. That's my opinion based on my own experience and my observations and the action of hundreds of investors over the years.

Do you want a simple, basic strategy for building a fortune? Here is the elusive secret that few people understand. When the primary trend of the market is bullish, build a portfolio of leading blue-chip, dividend-paying stocks and stay with those stocks as long as the primary trend remains bullish, always reinvesting the dividends. Then get out at or near the top of the bull market.

Once out, move your money into the safest and highest-yielding fixed income securities. These will usually be bonds, government or otherwise. That's it. Sounds easy? Unfortunately, it isn't. Why isn't it easy? It isn't easy because you need the knowledge to identify the primary trend of the market. Then you need the patience and will to stay with the bull market — and to stay out of the bear market.

Finally, you need the discipline to avoid other distractions, like the desire for the quick kill. You also need the discipline to stick with your strategy, despite the fact that there will always be a hundred distractions. In the end, to follow the strategy outlined above you need knowledge and you need discipline. Few people have either; even fewer people have both. Right now we have a typical test of the strategy. We know that bear markets end with stocks at great values. But stocks are still expensive. Therefore, on the value test this bear market is not completed yet.

You hear about the wonders of "the long term," meaning holding stocks for the long term. But like all simple formulas, this one is for simpletons. The fact is that it all depends when you enter the market, when you buy your stocks. If you buy your stocks when they are overvalued, if you had bought in 1929 or 1946 or 1966 or 1968 or 1971 or 1987 or 1999 or 2000, you may have to wait a decade or a quarter of a century to get even.

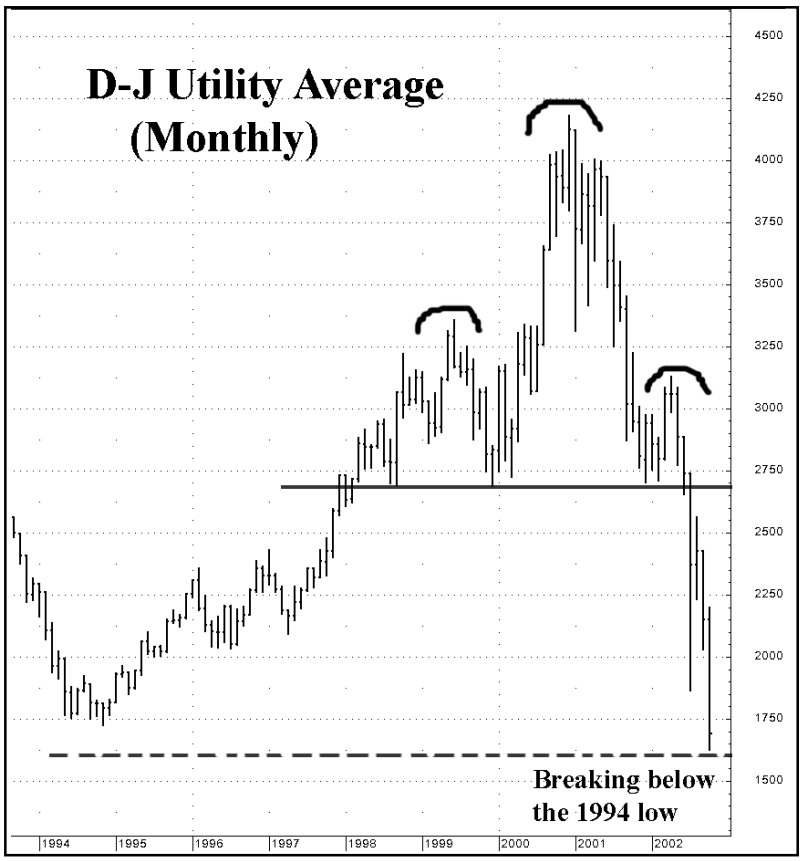
But if you bought your stocks at or near a bear market bottom such as 1942 or 1949 or 1974 or 1982 then you can probably hold your stocks forever and never look back. Or at least you can hold your stocks until the next bull market top.

Now I want to talk a bit about the ability of the stock market to look ahead, to discount the future. Many months ago I included in these Letters monthly charts of a number of stock indices.

One chart (on page 3) that fascinates me is the chart of the D-J Utility Average. On this monthly chart we can see that the Utility Average has formed a massive head-and-shoulders top. What is so interesting about this chart was the sheer height of the head. I don't know if I'd ever seen such a bearish chart. Usually, in a head-and-shoulders top the greater the size of the "head," the greater the count to the downside. This head was massive.

Was the market correct or was this a freak structure? What could this huge head portend? What could it be warning us about? Now we know. The staid old conservative Utility Average (bull market high was 416.11) has lost over half of its peak value. And now we hear that the utilities are in their worst shape since the Great Depression.

Who would have thought it? Who would have believed it? I'll tell you who – the market thought it, and the market believed it. The story was in the Utility Average; the story was in that giant formation. When the formation broke down I told my subscribers to bail out of the utilities.



At the time, my favorite utility stock was TXU. Merrill Lynch recommended TXU as their top choice in the Utility Sector. TXU was selling at the time for 48. Where is TXU now? It's selling for 12, down a spectacular 75% from its high. So are charts worth anything? Is technical analysis worth anything? You be the judge.

Next question – what about the current charts? What about the giant head-and-shoulders tops in all the major stock averages? They're not a happy sight. All of these head-and-shoulders formations have broken down, and they have all declined to the point where they are oversold. Meaning they have gone down too far without a correction.

So as I write we're in the corrective phase. The bear is in the process of punishing all those shorts who thought they were going to get rich by selling what they didn't own, and then delivering what they didn't own at lower prices. It worked beautifully for a while, but then the short side got too crowded, and it got too easy. The bear never likes speculators to make too much money "the easy way." He wants to be paid back. That's part of what bear market rallies are all about.

Of course, the bear also doesn't want his reign to end too quickly. It takes time to wipe out a good percentage of the stockholding population. Yeah, it takes time, and one way to extend the bear market is via periodic rallies. Bear market rallies give stockholders hope. It gives them the hope that somehow they'll break even, or maybe even get their money back.

And that's where we are now. Enjoying (unless we're short) a bear market rally, thrilling to the thought that maybe we're going to get our money back, get our 401(k) back to the plus side and get our stocks back to the starting point. But it won't happen. The bear is not that forgiving. He's no more forgiving than the prosecutors who are trying to put poor old Martha Stewart in prison. He's a cruel, insensitive, sadistic bear.

NOTES & QUOTES — Why do so many Muslims hate the US? The following is from a fine article that appeared in the *Washington Post*.

"Most Muslims, unlike most Americans, have an intense historical awareness and see the current events in a much deeper and broader perspective than we normally do. And what they see is, for them, profoundly tragic.

For many centuries Islam was the greatest civilization on earth – the richest, the most powerful, the most creative in every significant field of human endeavor. It's armies, its teachers and its traders were advancing on every front in Asia, in Africa, in Europe, bringing, as they saw it, civilization and religion to the infidel barbarians who lived beyond the Muslim frontier.

And then everything changed, and Muslims, instead of invading and dominating Christendom, were invaded and dominated by Christian powers. The resulting frustration and anger at what seemed to them a reversal of both natural and divine law

have been growing for centuries and have reached a climax in our own times. These feelings find expression in many places where Muslims and non-Muslims clash – in Bosnia, Sudan, Kashmir, and the Philippines, among others. The prime target of the resulting anger is, inevitably, the US, now the unchallenged, if not unquestioned, leader of what we like to call the free world and what others variously define as the West, Christendom and the world of the unbelievers.

Some Arab leaders try frantically to find a substitute for the Soviet Union as patron and protector of anti-American causes and have evoked a limited and for the most part ineffective response in some quarters in Europe. Others, notably Osama bin Laden, took a different view. As they saw it – and their view does not lack plausibility – it was they who by the holy war they waged in Afghanistan, brought about the defeat and collapse of the Soviet Union. In their perspective, they had dealt with one of the infidel superpowers – the more determined, the more ruthless and the more dangerous of the two. Dealing with the soft and pampered US would, so it seemed, be much easier.

A more important question, less frequently asked, is the reason for the contempt with which they regard us. The basic reason for this contempt is what they perceive as the rampant immorality and degeneracy of the American way – contemptible but also dangerous because of its corrupting influence on Muslim societies. What did the Ayatollah Khomeni mean when he repeatedly called America the "Great Satan"? The answer is clear. Satan in not an invader, an imperialist, and exploiter. He is a tempter, a seducer, who in the words of the Koran, "whispers in the hearts of men."

Russell Comment: Yes, I think this is the essence of Muslim hatred towards the US. The US is the great exporter of US culture. This is what the youth of the world find so seductive. The most popular program in the world for youth is MTV. Compare the MTV culture with the Muslim culture. This is the great threat to hard-core Muslims. MTV is sex, rock-and-roll, half dressed teen-agers and freedom to say and do what you want. That's a great danger to a closed society. US culture appeals to youth around the world. US culture, our most successful export, is the great danger to Muslim society.

* * * *

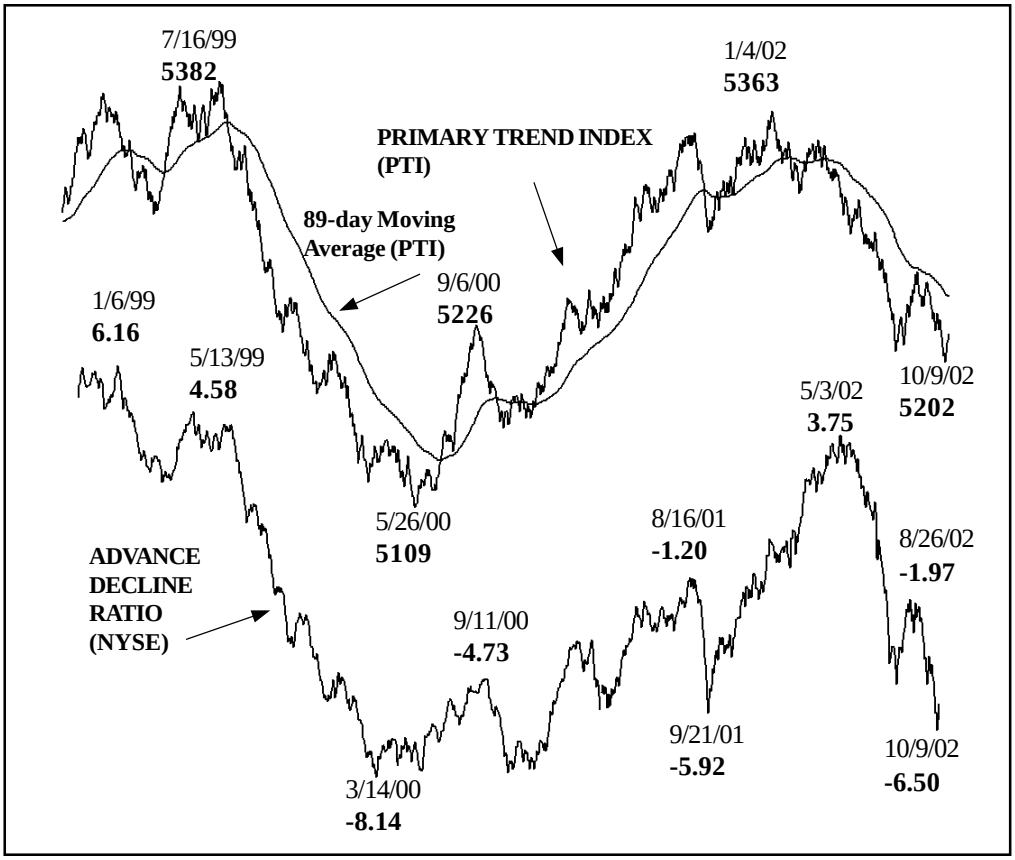
I've been looking through the *Forbes* annual "400 Richest People in America" issue. The 400 lost a total of around $80 billion since the last tally, courtesy of the bear market. Of the 400 who were there in 1982, only 64 are left. They either died or lost enough money so that they have been dropped off the list. I was particularly struck by the three Mars people, who were worth $10 billion each – all from candy (did you ever try a Mars bar?). Then there are the five (5) Waltons who are worth $18.8 billion (that's billion) a piece. Gates ($43 billion) and Buffett ($36 billion) still head the list. Gates is down $11 billion, but I imagine he's still eating steak. Buffett is actually up a bit this year. Dropped from the list is poor Martha Stewart.

BEAR MARKET LOSSES – I hate to bring this up, but I've received so many e-mails telling me about tragic losses that I feel I should write something along these lines. I've written many times that in a primary bear market, everybody sustains losses. In fact I developed a thesis that runs like this – "In a bear market everyone loses – and the winner is the person who loses the least."

When I first wrote this seemingly nasty little sentence, people were incensed. They thought it was too cynical. They thought this little sentence didn't apply to them. I believe after three years of this bear market the "unbelievers" have changed their minds. When I publish this sentence now, I don't receive any complaining e-mails or letters.

Look what's happened. Stocks have been hit hard. People moved into bonds. Now bonds are getting whacked. How about gold? Gold has been hit hard. Foreign stocks were supposed to be the place to be. But all the foreign stock averages (with the exception of Norway and I think Thailand) have suffered.

What's left? The dollar itself plus real estate and homes. My own guess is that both the dollar and real estate are living on borrowed time. Of course T-bills and cash have been the best places to be in this bear market. But it is interesting how one sector after the other has been hurt and in most cases hurt badly by the bear market.



So if you've lost money so far in this, the greatest bear market since the 1930s, don't feel too badly. Everybody's lost money. And remember, the person who's lost the least is the winner.

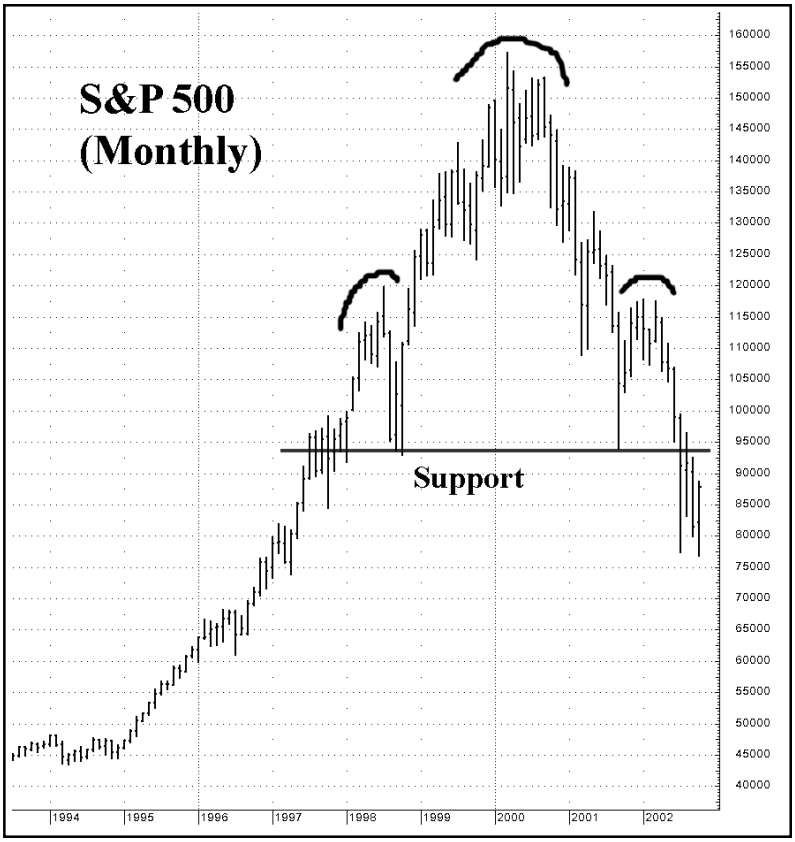
COMMENTS — The chart at left shows the "real" advance-decline ratio breaking below it's September low. This move was confirmed by my PTI. However, note that the A-D ratio (common stocks only) has assumed the form of a huge head and shoulders top. There is plenty of room for the A-D ratio to rally and even challenge its August peak, but it's clear that we've seen the high for the A-D ratio, which was recorded on May 3, 2002.

Now turn to the chart below, which is a monthly chart of the widely followed S&P Composite. Here we see a "perfect" head-and-shoulders top. The "neckline" or support for the S&P formation comes in at about 940. This allows for a lot of room for the S&P to rally before the S&P even comes into heavy "supply." The supply should be all the stocks which lie above the support line as seen on the chart.

The important thing that I want to show is this picture of the S&P, an S&P which has clearly topped out. The head-and-shoulders formation provides a "technical" count. The count is measured from the top of the head down to the support line.

If we take that measurement and extend it below the support line, we can see that the S&P has a "target" on the downside of around 400. How the S&P gets from here to there will be the story of how this bear market unwinds. My guess is that it's going to be an extended, very convoluted story, taking years.

This monthly chart traces one of the largest topping formations in stock market history. A massive distribution has taken place. The resolution of this distribution could be the stock market story of the next decade.



INVESTMENT POSITION – The bear is in box, in fact he moved into the box in September 1999, when the stock market turned bearish under Dow Theory, and he's never left.

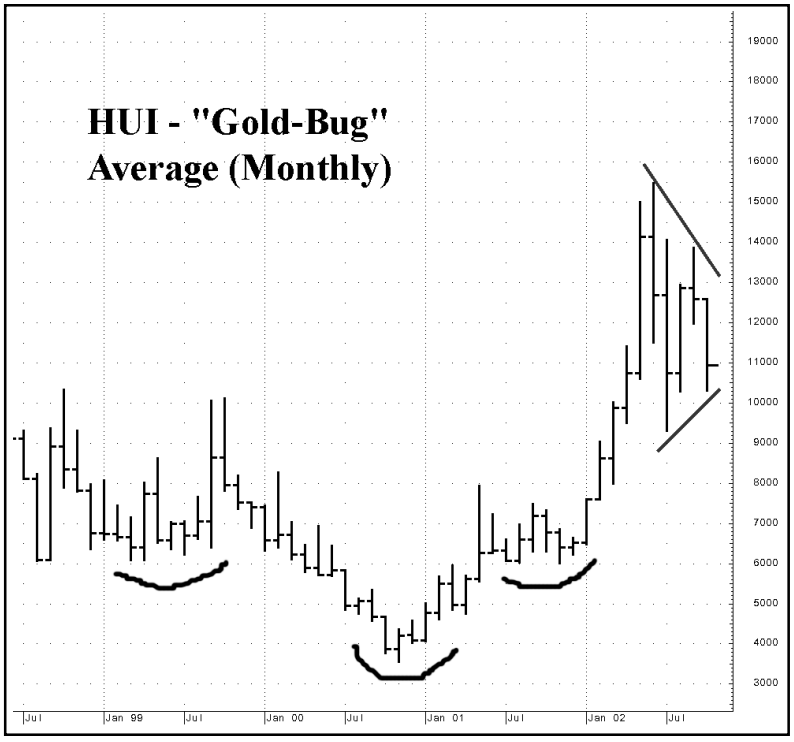
I spent an hour in our largest La Jolla bookstore going through the indexes of about 50 "how to invest" books (and there are a surprising number of these books now in print). I was looking for one word, "compounding." I didn't find that word in any of the books. And that too was surprising.

During a bull market the strategy is to buy a selection of good, dividend-paying stocks and to just keep buying. You want all the stock you can carry in a bull market. You let the bullish forces work for you. It's as simple and basic as that.

Now we're in a bear market, and the strategy is to compound with the safest products you can find. My thesis from the beginning was that this bear market was going to spell "deflation," and as such the money was going to be made in bonds. I live in a high-tax state and my first choice was municipal bonds of the highest grade, bonds rated AAA. That's what I did, and I told my subscribers to load up with bonds. As the interest comes in, buy more bonds. Then about a year-and-half ago I added gold and gold shares to the mix. And that's where I am today. Bonds and gold – really nothing else.

LATE NOTES – There have been a lot of questions about the gold shares. Here's what I think is happening. I've included a monthly chart of HUI, the Amex "Gold-Bug" average of unhedged gold shares. What I see here is a huge base in the form of a complex head-and-shoulders bottom.

In March 2000 HUI broke up and out of its base. Then beginning in May 2002 HUI started to form a giant symmetrical triangle. As I write, HUI is still within the confines of the triangle. What gold bulls can hope for is that in due time HUI will break out of this triangle to the upside. That's what I believe will happen. It may take a few more months, possibly even longer for HUI to head higher.



Those who follow my thoughts on the daily website know that I believe that October 9 was a temporary but possibly important low for the stock market. At least that's my guess at this time. For this reason, I also suggested speculative bull positions for those who have the courage and the stomach to "play" an up-side correction in a bear market.

For the "ammunition" to play the upside, I suggested Diamonds (DIA) which are proxies for the Dow, Spyders (SPY) which are proxies for the S&P and "cubes" or QQQs, which are proxies for the Nasdaq. All three are traded just like regular stocks and they are traded on the Amex. Stop losses should be placed 8% below your purchase price.

Next Mailing: November 14, 2002